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TAX REVISION ISSUES—1976 (H.R. 10612)

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BUSINESS RELATED INDIVIDUAL INCOME TAX REVISIONS

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by the staff of the

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CONTENTS

INTRODUCTION

This pamphlet presents background information regarding a series of matters contained in the House-passed bill (H.R. 10612) relating to the income tax deduction of business or investment related expenses of individuals. This pamphlet discusses in each case the present law treatment, the issues which have been raised and how these matters are dealt with in the House-passed bill. Subsequent pamphlets will discuss alternative proposals for dealing with these problems.

The matters discussed in this pamphlet include the tax treatment of expenses related to the business use of homes, vacation homes and foreign conventions, the tax treatment of qualified stock options, the treatment of losses from nonbusiness guarantees, and the away from home expenses of state and congressional legislators.

1. Business Use of Home

Present law

Under present law, deductions are allowed for personal, living, and family expenses only to the extent expressly allowed under the code. Generally, expenses and losses attributable to a dwelling which is occupied by a taxpayer as his personal residence are not deductible. However, deductions for interest, certain taxes, and casualty losses attributable to a personal residence are allowed under other provisions of the tax laws. In addition, if a portion of the residence is used in the taxpayer's trade or business or is used in the production of income, a deduction may be allowed for a portion of the expenses incurred in maintaining the residence.

In any case involving the business use of a personal residence, it must be established that the expenses were incurred in carrying on a trade or business or for the production of income. Under the regulations, the expenses of maintaining a household are treated as nondeductible if the taxpayer only incidentally conducts business in his home. However, if a part of the house is used as the taxpayer's place of business, the allocable portion of the expenses attributable to the use of the home as a place of business is allowed as a deduction.

For this purpose the expenses attributable to the business use of the home are deductible if they are "ordinary and necessary" expenses paid or incurred in carrying on a trade or business or for the production of income. Deductions are allowed self-employed individuals who use portions of their residences for trade or business purposes, employees who maintain offices in connection with the performance of their duties as employees, or investors who maintain offices in connection with investment activities. Typically, the expenses for which a deduction is claimed include a portion of the depreciation or rent, maintenance, utility, and insurance expenses incurred in connection with the residence.

The position of the Internal Revenue Service is that the maintenance of the office in the home must be required by the employer as a

condition of employment and regularly used for the performance of the employee's duties. Certain courts have decided that a more liberal standard is appropriate. Under these decisions, the expenses attributable to an office maintained in an employee's residence are deductible if the maintenance of the office is "appropriate and helpful" to the employee's business: *George H. Newi*, T.C. Memo. 1969–131, aff'd 432 F. 2d 998 (2d Cir. 1970); *Jay R. Gill*, T.C. Memo. 1975–3; *Hall* v. *United States*, 387 F. Supp. 612 (D.C.N.H., 1975).

In *Stephen A. Bodzin*, 60 T.C. 820 (1973), the Tax Court, in allowing a deduction for an office in an employee's residence, held that "the applicable test for judging the deductibility of home office expenses is whether, like any other business expense, the maintenance of an office in the home is appropriate and helpful under all the circumstances." However, the court cautioned that no deduction would be allowable if personal convenience were the primary reason for maintaining the office notwithstanding any conclusion as to the "appropriateness" and "helpfulness" of the office. On appeal, the Fourth Circuit reversed the decision of the Tax Court (509 F. 2d 679). The Appellate Court held that, as a factual matter, the expenses attributable to the taxpayer's residence were nondeductible personal expenses and that it was therefore unnecessary to decide if the maintenance of the office was appropriate and helpful in carrying on his business. The court suggested that to obtain a deduction, an employee would have to show that the office provided by the employer is not available at the times the employee uses the office in his residence or that the employer's office is not suitable for the purposes for which the taxpayer is using the office in his residence.[1]

In determining the deductible amount attributable to the business use of the home, the general rule is that any reasonable method of allocation may be used. In all cases involving the dual use of a home, the allocation of expenses attributable to the portion of the residence used for business purposes is to take into account the space used for those purposes, e.g., a percentage of the expenses based on the square feet of that portion compared to the total square feet of the residence. In addition, a further allocation based on time of use is required. The Internal Revenue Service has ruled that this allocation should be made on the basis of availability for use rather than actual use. However, the Tax Court has held that such expenses should be allocated on the basis of actual business use as compared with actual total use.

In another case where the allocation between business use and personal use could not clearly be determined, the allocation was made on the basis of the approximate space of an apartment which was used for business purposes.

Issue

Some favor a definitive rule to resolve the conflict that exists between several recent court decisions and the position of the Internal Revenue Service to determine the deductibility of expenses attributable to the maintenance of an office in the taxpayer's personal residence.

It is pointed out that under the "appropriate and helpful" standard employed in the court decisions the determination of the allowance of

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[1] The Supreme Court denied certiorari in the *Bodzin* case on October 6, 1975 (44 U.S.L.W. 3201).

a deduction for these expenses is necessarily a subjective determination. In the absence of definitive controlling standards, it is stated that the "appropriate and helpful" test increases the inherent administrative problems because both business and personal uses of the residence are involved. It is also argued that in many cases the application of the appropriate and helpful test results in treating personal, living, and family expenses directly attributable to the home (and therefore not deductible) as ordinary and necessary business expenses, even though those expenses did not result in additional or incremental costs incurred as a result of the business use of the home. Thus, it is contended that expenses otherwise considered nondeductible personal, living, and family expenses are converted into deductible business expenses simply because, under the facts of the particular case, it was appropriate and helpful to perform some portion of the taxpayer's business in his personal residence even though only minor incremental expenses were incurred in order to perform these activities.

The House bill

Under the House bill, the taxpayer would not be permitted to deduct any expenses attributable to the use of his home for business purposes except as provided below.

Deductions for expenses attributable to the use of a portion of the taxpayer's residence for business use would be permitted with respect to the portion of the home used exclusively on a regular basis as:

(1) the taxpayer's principal place of business, or

(2) a place of business which is used for patients, clients, or customers in meeting or dealing with the taxpayer in the normal course of business.

However, under these two exceptions, deductions could not exceed the income generated by the business activity of the taxpayer in his home. Deductions would be permitted for certain inventory storage. In addition, in the case of an employee, the business use must be for the convenience of his employer.

This provision would apply to taxable years beginning after December 31, 1975.

2. Vacation Homes

Present law

Under present law, in order to be entitled to a deduction for business or investment expenses, it is necessary that the activity in which such expenses are incurred be engaged in by the taxpayer for profit (i.e., for the purpose of or with the intention of making a profit).[1] The determination of whether an activity is engaged in for profit is made on the basis of objective standards, taking into account all facts and circumstances of each case. Although a reasonable expectation of profit is not required, the facts and circumstances (without regard to the taxpayer's subjective intent) must indicate that the taxpayer entered the activity or continued the activity with the objective of making a profit. However, a deduction is allowed for interest, State and local property taxes, and casualty losses without regard to whether they are incurred in connection with a trade or business or for the production of income

In addition, in the case of an activity not engaged in for profit, a deduction is allowed for expenses which could be deducted if the activity were engaged in for profit, but only to the extent these expenses do not exceed the amount of gross income derived from the activity reduced by the deductions which are allowed in any event (e.g., interest and certain State and local taxes). In other words, as to expenses such as depreciation, insurance, and maintenance, a taxpayer is allowed a deduction but only to the extent of income derived from the activity.

A taxpayer is presumed to be engaged in an activity for profit if, in two or more years out of the last five years (seven years in the case of the breeding, training, showing, or raising of horses) the activity was carried on at a profit. For this purpose an activity is treated as being carried on for a profit in a year if the gross income from the activity exceeds the deductions attributable to it.

The Regulations provide a list of factors to be taken into account in determining whether the activity is engaged in for profit. Among other factors, the presence of personal motives must be considered, especially where there are recreational or personal elements involved.[2] By way of illustration, the regulations provide that a taxpayer will be treated as holding a beach house primarily for personal purposes if, during a three-month season, the beach house is personally used by the taxpayer for one month and used for the production of rents for the remaining two months. However, except for this example, there are no definitive rules relating to how much personal use of vacation property will result in a finding that the rental activities of vacation homes are not engaged in for profit.

Issue

Where expenses attributable to a residence are treated as deductible business expenses, it has been argued that an opportunity exists to convert nondeductible personal, living and family expenses into deductible expenses. In the case of so-called "vacation homes" that are used both for personal purposes and for rental purposes, many feel that frequently personal motives predominate and the rental activities are undertaken to minimize the expenses of ownership of the property rather than to make an economic profit.

It has been pointed out that in selling vacation homes, it is common practice to emphasize that tax benefits can be obtained by renting the property during part of the year, while reserving the remaining portion for personal use. In addition, arrangements have been devised whereby an individual owner of a condominium unit is entitled to exchange the time set aside for the personal use of his own unit (typically three to six weeks) for the use of a different unit under the same general management.

Under many of these arrangements, it is suggested that it is extremely difficult under existing law to determine when an activity is engaged in for profit. It is noted that the present regulations provide that, in making this determination, a number of factors shall be taken into account. These factors include the presence of "personal motives," especially where there are recreational or personal elements involved.

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[1] See *Morton* v. *Commissioner*, 174 F. 2d 302, 304 (2d Cir.), cert. denied, 338 U.S. 828 (1949); *Schley* v. *Commissioner*, 375 F. 2d 747 (2d Cir. 1967); and *George W. Mitchell*, 47 T.C. 120 (1966).

However, except for the example mentioned above, no objective standards are set forth in the regulations. As a result, many believe that definitive rules need to be provided to specify the extent to which personal use would result in the disallowance of deductions in excess of gross income. It is suggested that this approach would obviate the need to require subjective determinations to be made concerning the taxpayer's motive and the primary purpose for which the vacation home is held.

In addition, if there is any personal use of a vacation home, it has been urged that the portion of expenses allowable to rental activities should be limited to an amount determined on the basis of the ratio of time the home is actually rented to the total time the vacation home is used during the taxable year for all purposes (i.e., rental, business, and personal activities).

The House bill

Under the House bill, if a vacation home is used by a taxpayer for personal purposes for the greater of 2 weeks or 5 percent of the actual business use (that is its actual rental time), the deductions incurred in connection with a vacation home, which would be allowed cannot exceed the gross income from the business use of the vacation home. These rules would not apply if the rental of a vacation home results in a profit for the year.

In addition, where the 2 weeks or 5-percent rule applies, the deductions treated as being attributable to the rental activities would be limited to the proportion which actual rental use bears to the total actual use of the property (that is, business use plus personal use) times the business expenses attributable to the vacation home (other than expenses which are allowable in any event, such as interest and taxes).

This provision would apply to taxable years beginning after December 31, 1975.

3. Foreign Convention Expenses

Present law

Generally, to be deductible, traveling expenses must be reasonable and necessary in the conduct of the taxpayer's business and directly attributable to the trade or business. If a trip is primarily related to the taxpayer's business and the special foreign travel allocation rules do not apply, the entire traveling expenses (including food and lodging) to and from a destination are deductible. If a trip is primarily personal in nature, the traveling expenses to and from the destination are not deductible even if the taxpayer engages in business activities while at the destination.[1] However, expenses incurred while at the destination which are allocable to the taxpayer's trade or business are deductible even if the transportation expenses are not deductible.

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[2] Treas. Reg. § 1.183-2(b). These factors include: (1) The manner in which the taxpayer carries on the activity, (2) the expertise of the taxpayer or his advisors, (3) the time and effort expended by the taxpayer in carrying on the activity, (4) the expectation that assets used in the activity may appreciate in value, (5) the success of the taxpayer in carring on other similar or dissimilar activities, (6) the taxpayer's history of income or losses with respect to the activity, (7) the amount of occasional profits, if any, which are earned, (8) the financial status of the taxpayer, and (9) the elements of personal pleasure or recreation.

[1] See *Patterson* v. *Thomas*. 289 F. 2d 108 (5th Cir. 1961); *Espandiar Kadivar*, T.C. Memo 1973-95; Rev. Rul. 74-292, 1974-1 C.B. 43.

With respect to expenses incurred in attending a convention or other meeting, the test is whether there is a sufficient relationship between the taxpayer's trade or business and his attendance so that he is benefiting or advancing the interests of his trade or business. Generally, deductibility depends upon the facts and circumstances of each particular case. If the convention is for political, social, or other purposes unrelated to the taxpayer's business, the travel expenses are not deductible. The Internal Revenue Service has ruled that the test for allowance of deductions for convention expenses is met if the agenda of the convention or other meeting is so related to the taxpayer's position as to show that attendance was for business purposes.

If an individual travels away from home primarily to obtain education for which the expenses are deductible as trade or business expenses, the expenses for travel, meals, and lodging incurred while away from home are deductible. However, the portion of the travel expenses attributable to personal activities, such as sightseeing, is treated as a nondeductible personal or living expense. If the travel away from home is primarily personal, only the meals and lodging incurred during the time spent in participating in educational pursuits are deductible.

Expenses of travel outside the United States are deductible only to the extent they are allocable to the taxpayer's trade or business or income-producing activities if the travel is for more than one week or the time of travel outside the United States which is personal is 25 percent or more of the total time on such travel. In the case of foreign travel, this allocation requirement overrides the general rule that the entire expenses of travel are deductible if the primary purpose of the trip was related to a trade or business.

Issue

Questions have been raised as to the recent proliferation of conventions, educational seminars, and cruises which are ostensibly held for business or educational purposes, but which, it is alleged, are held at locations outside the United States primarily because of the recreational and sightseeing opportunities. The Internal Revenue Service has announced that it intends to scrutinize deductions for business trips, conventions, and cruises which appear to be vacations in disguise. The Service noted that a number of professional, business and trade organizations have been sponsoring cruises, trips and conventions during which only a small portion of time is devoted to business activity and that the practice seemed to be growing. In cases where there are indications of abuse, the Service intends to request lists of the names and addresses of the participants on cruises and other trips. However, allowance of deductions claimed by participants would continue to depend upon the facts and circumstances, including the relationship of the meeting to a particular taxpayer's trade or business, as under present law.

As indicated above, the basic test applied by the Internal Revenue Service is whether the convention or other meeting is primarily related to the taxpayer's business or whether it is primarily personal in nature. In administering this test, the Internal Revenue Service is required to make a subjective determination as to the motives and intentions of the taxpayer after taking into account all the facts and

circumstances in a particular case. One of the important factors considered by the Service in making this subjective determination is the amount of time spent on business activities as compared to the amount of time spent on personal activities. There are no specific guidelines or formulae in the statute or regulations that specify when this factor will weigh in favor of, or against the taxpayer. The taxpayer is not required to keep detailed records relating to the amount of time spent on each of these activities. Upon audit, the taxpayer frequently attempts to substantiate the business nature of his trip by providing the Service with the agenda from the meeting or a certificate of attendance which is furnished by the organization sponsoring the meeting.[2]

The Service has indicated that the administrative problems created by the lack of specific guidelines are substantial. The process of trying to ascertain all the facts and circumstances is extremely time consuming both for the taxpayer and the Service. It has been suggested that it is particularly difficult for the Service because of the basically "all or nothing" approach for transportation expenses under present law. If the primary purpose is determined to be pleasure, no amount of the travel expense can be deducted. Since reasonable and competent auditors will differ in evaluating all the facts and circumstances, it is suggested that the deduction of one taxpayer may be totally disallowed while another taxpayer (perhaps with slightly different facts) can obtain a complete deduction for travel expenses. This disparity of treatment results in complaints that the Service does not treat taxpayers equally.

Some believe that the lack of specific detailed requirements has resulted in a proliferation of foreign conventions, seminars, cruises, etc. which, in effect, amount to Government-subsidized vacations and serve little, if any, business purpose. The promotional material often highlights the deductibility of the expenses incurred in attending a foreign convention or seminar and, in some cases, describes the meeting in such terms as a "tax-paid vacation" in a "glorious" location. In addition, there are organizations that advertise that they will find a convention for the taxpayer to attend in any part of the world at any given time of the year. It has been suggested that this type of promotion has an adverse impact on public confidence in the fairness of the tax laws.

The House bill

Under the House bill, a limitation would be imposed on deductions allowable for the expenses of taxpayers attending conventions, educational seminars, or similar meetings outside the United States, its possessions and the Trust Territory of the Pacific. Deductions would be allowed for expenses incurred in attending not more than two foreign conventions per year. With respect to these two conventions, the amount of the deduction for transportation expenses could not exceed the cost of airfare based on coach or economy class. Transportation expenses would be deductible in full only if more than one-half of the total days of the trip (excluding the days of transportation to and from the site of the convention) are devoted to business-related activities.

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[2] A few organizations now maintain attendance records and require participants to "sign in" at each session of the convention or seminar.

If less than one-half of the total days of the trip are devoted to business related activities, no deduction would be allowed for that portion of the transportation expenses attributable to non-business-related activities.

In addition, deductions for subsistence expenses, such as meals, lodging, and other ordinary and necessary expenses, paid or incurred while attending the convention would be limited to the fixed amount of per diem allowed to government employees at the location where the convention is held. However, in order to be able to deduct subsistence expenses up to this limitation, there must generally be at least 6 hours of business-related activities scheduled daily and the taxpayer must have attended two-thirds of these activities.

This provision would apply to conventions held after December 31, 1975.

4. Qualified Stock Options

Present law

An employee stock option is a relatively low risk means of acquiring an equity interest in a corporation, since the option need not be exercised unless the value of the stock increases during the option period. If the value of the stock drops below the price at which the stock may be purchased (i.e., below the option price), the employee can allow the option to lapse (although ordinarily the employee would lose the amount which he may have originally paid for the option, if any).

Under present law, no income is recognized on the grant to a corporate employee, or on his exercise of, a "qualified" option to receive stock in the employer corporation. The stock acquired by the exercise of the option is a capital asset in the hands of the employee and the income realized from the eventual sale of the stock is generally treated as long-term capital gain or loss.[1]

No deduction is available to the employer, as a business expense with respect to either the granting of a qualified stock option or the transfer of stock to the employee when he exercises a qualified option.

A qualified option must be granted pursuant to a plan approved by the shareholders of the corporation. The option must, by its terms, be exercised within 5 years from the date it is granted and the purchase price of the shares (option price) may not be less than the fair market value of the company's stock on the date when the option is granted to the employee. In addition, any stock acquired under a qualified option may not be disposed of within 3 years after it is transferred to the employee. The option must also be exercised while the option holder is an employee of the corporation, or within three months after the termination of his employment.

By contrast, the value of a nonqualified stock option generally represents ordinary income to the employee if the option itself had a readily ascertainable fair market value at the time it was granted to the employee. If the option did not have a readily ascertainable value when granted, it would not constitute ordinary income at the time it was granted but when it is exercised the spread between the option

[1] Generally similar tax treatment is also available in the case of "restricted stock options," which were the predecessors to qualified options, but restricted stock options are no longer being granted, and most restricted options which were granted in the past have now been exercised or have lapsed.

price and the value of the stock at that time constitutes ordinary income to the employee.

Although an employee does not have to pay tax under the qualified stock option rules at the time he exercises the option and receives stock worth more than he paid for it, the bargain element is treated as an item of tax preference under present law. This means that the excess of the fair market value of the share at the time of exercise over the purchase price paid by the employee is subject to the 10-percent minimum tax under present law.

Issue

The principal reason for the present tax treatment of qualified stock options is said to be that such treatment allows corporate employers to provide "incentives" to key employees by enabling these employees to obtain an equity interest in the corporation. However, questions have been raised as to whether a qualified stock option gives key employees more incentives than do any other form of compensation, especially since the value of compensation in the form of a qualified option is subject to the uncertainties of the stock market. It is also noted that the market price of a company's stock is subject to many variables and the connection between an employee's own efforts and the value of the stock is, at best, speculative, particularly in the case of a large publicly traded corporation with many employees. Moreover, to the extent there is an incentive effect resulting from stock options, it is argued that present law discriminates in favor of corporations (which are the only kind of employers who can grant qualified options) as opposed to all other forms of business organization.

Qualified stock options have become less attractive as a compensation technique in recent years because of the generally declining stock market of recent years. The market price of stocks of many publicly held companies has dropped substantially in the recent recession. As a result, many qualified stock options granted in previous years at purchase prices which seemed attractive on an assumption that the price of the company's stock would rise became unattractive as the price of the outstanding stock fell. Many executives thus had no incentive to exercise their options which were "under water," i.e. options whose exercise price was higher than the current level of the company's stock in the open market. Because of this loss-of-incentive feature many companies have turned to other techniques and plans as a way to compensate their executives.

Some companies, however, have gone ahead and granted new qualified options to their executives at the currently depressed market prices of their stock. The rationale has been that the executives may still be able to benefit by the new options if the price of the stock does increase in the years ahead and if the executives do not have to wait too long to exercise the new options. In some cases, such new grants of qualified stock options to executives in the recession has produced increasing criticism from the shareholders of the companies. Some such shareholders have argued that the grant of new qualified options enables the companies' executives to avoid taking the same business risks that the shareholders generally are taking with regard to the company's fortunes.

The House bill

Under the House bill, in the future, qualified stock options would be subject to the same rules as presently apply in the case of most nonqualified options. Generally, the value of the option would constitute ordinary income to the employee if it had a readily ascertainable fair market value at the time it was granted (and was not nontransferable and subject to a substantial risk of forfeiture). If the option did not have a readily ascertainable value, it would not constitute ordinary income at the time it was granted, but when the option was exercised the spread between the option price and the value of the stock would constitute ordinary income to the employee.

In general, the new rules would apply to options granted after September 23, 1975, but would not apply to options granted on or before this date. This is true even though the option is exercised in the future (so long as it meets the terms of the present rules of a qualified option). In addition, transition rules would be provided for options granted after September 23, 1975, pursuant to a written plan adopted and approved before September 24, 1975; for options granted after September 23, 1975, under a qualified plan adopted by a board of directors before September 24, 1975, even if the plan was approved by the shareholders after that date; and for substitute options granted after September 23, 1975, as a result of a corporate reorganization or similar transaction provided that no modification of the former option occurs. The transition rules cover these options as long as they are exercised before September 24, 1980.

These rules would apply to taxable years ending after September 23, 1975.

5. Treatment of Losses From Certain Nonbusiness Guaranties

Present law

Under present law, in the case of a noncorporate taxpayer, business bad debts are deductible as ordinary losses for the year in which the debt becomes worthless or partially worthless. On the other hand, nonbusiness bad debts are treated as short-term capital losses, which means that the losses are offset first against the taxpayer's capital gains (if any), and may then be deducted against ordinary income to the extent of $1,000 per year.

However, where the noncorporate taxpayer's loss results from a situation where he guaranteed the debt of a noncorporate person, and was required to make good on that guaranty because the borrower defaulted, present law provides that the guarantor may treat the payment under the guaranty as a business bad debt (even though the guaranty did not arise in connection with the guarantor's trade or business) if the proceeds of the loan were used by the borrower in his trade or business. However, the guarantor of a corporate obligation which becomes worthless must treat the guaranty payment as a nonbusiness bad debt.

If the loan is not used in the borrower's trade or business, the guarantor's payment will still be deductible as a nonbusiness bad debt (short-term capital loss) if the debt is worthless when paid and the guarantor has a right of reimbursement (subrogation) against the borrower.[1]

In cases where the guarantor has no right of subrogation, there has been some uncertainty as to whether, and under what circumstances, the guarantor was entitled to deduct his guaranty payment. For some time it was believed that the payment could not be deducted as a bad debt on the theory that unless there is a right of recovery against the borrower, there is no "debt" which might become worthless in the hands of the guarantor. However, if the guaranty transaction was entered into in connection with the taxpayer's trade or business, or the agreement was part of a transaction entered into for profit on the part of the taxpayer, then the payment was thought to be deductible as a loss under section 165.

Recently, courts have found an implied promise on the part of the borrower to reimburse the guarantor for his payments, and holding that this implied promise constituted the bad debt.[2] Thus, taxpayers were required to claim their deduction under section 166. However, there is no assurance that the rationale of these cases will be applicable in all fact situations where there is potential for avoidance of the bad debt rules, or that these opinions will be followed in every jurisdiction.

Issue

As discussed above, where a taxpayer makes a loan which is not connected with his trade or business, and the debt becomes worthless, he is generally required to treat the loss as a short-term capital loss. On the other hand, it is pointed out that where the taxpayer and the borrower can persuade a third party to make the loan, which is guaranteed by the taxpayer, and the proceeds of the loan are used by the borrower in his trade or business, the loss, if one results, may generally be deducted by the taxpayer against ordinary income. Questions have been raised as to whether this distinction makes sense. It appears to provide a tax incentive for careful planning, particularly in transactions between closely related parties, such as family members, with no emphasis on the actual substance of the loan transaction.

Another issue is whether there should be clarification in the case of a guarantor of a corporate obligation that any payment under the guaranty agreement must be deducted as a nonbusiness bad debt, regardless of whether there is any right of subrogation, unless the guaranty was made pursuant to the taxpayer's trade or business.

The House bill

Under the House bill, where a taxpayer has a loss arising from the guaranty of a loan, he would receive the same treatment as where he has a loss from a loan which he makes directly. Thus, if the guaranty agreement arose out of the guarantor's trade or business, the guarantor would still be permitted to treat the loss as an ordinary loss. If the guaranty agreement were a transaction entered into for profit by the guarantor (but not as a part of his trade or business), he would treat the loss as a short term capital loss. This rule would also apply in the case of a guarantor of a corporate obligation.

These rules would apply to taxable years beginning after December 31, 1975.

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[1] If the debt is not worthless, no deduction is generally allowed (on the theory that payment by the grantor was voluntary).

[2] See e.g., *Bert W. Martin*, 52 T.C. 140 (reviewed by the Court), aff'd per curiam, 424 F. 2d 1368 (9th Cir.) cert. denied, 400 U.S. 902 (1970).

6. Away From Home Expenses of State and Congressional Legislators

Present law

Under present law, an individual is allowed a deduction for traveling expenses (including amounts expended for meals and lodging) while away from home in the pursuit of a trade or business. These expenses are deductible only if they are ordinary and necessary in the taxpayer's business and directly attributable to it. "Lavish or extravagant" expenses are not allowable deductions. In addition, no deductions are allowed for personal, living, and family expenses except as expressly allowed under the code.

Generally, expenses and losses attributable to a dwelling unit which is occupied by a taxpayer as his personal residence are not deductible. However, deductions for interest, taxes, and casualty losses attributable to a personal residence are expressly allowed under other provisions of the tax laws.

A taxpayer's "home" for purposes of the deduction for traveling expenses generally means his principal place of business or employment. Where a taxpayer has more than one trade or business, or a single trade or business which requires him to spend a substantial amount of time at two or more localities, his "home" is held to be at his principal place of business. A taxpayer's principal place of business is determined on an objective basis taking into account the facts and circumstances in each case. The more important factors to be considered in determining the taxpayer's principal place of business (or tax home) are: (1) the total time ordinarily spent by the taxpayer at each of his business posts, (2) the degree of business activity at each location, (3) the amount of income derived from each location, and (4) other significant contacts of the taxpayer at each location. No one factor is determinative.

In 1952, a provision was adopted with respect to the living expenses paid or incurred by a Member of Congress (including a Delegate or Resident Commissioner). Under these rules, the place of residence of a Member of Congress within the congressional district which he represents in Congress is considered his tax home. However, amounts expended by the Member within each taxable year for living expenses are not deductible in excess of $3,000. Therefore, a Member of Congress (who does not commute on a daily basis from his congressional district) [1] can deduct up to $3,000 of his expenses of living in the Washington, D.C. area.

These rules do not apply in the case of a State legislator. As a result, the tax home of a State legislator is determined in accordance with the general rules described above. In a situation where a State's legislature is in session for a significant portion of the year, that State's legislators' homes, may, under these rules, be at the State capital rather than in their legislative districts.

Issue

In recent years, the sessions of many State legislatures have been substantially lengthened. As a result, members of the various legislatures are required to spend substantial portions of each year in the

[1] Under the "overnight rule," travel away from home expenses (as distinguished from transportation expenses) generally cannot be deducted unless the taxpayer is away from home on business overnight.

State capital. In order to reimburse the legislators for the living expenses incurred in connection with attending sessions in the State capital, many legislatures provide a per diem for each day a legislator attends a session of the legislature.

It is stated that it is extremely difficult for many State legislators to determine their tax homes under the facts and circumstances test of present law. First the length of time that a State legislature is in session may vary substantially from year to year. Moreover, several State legislatures meet only once every two years. In addition to the variation of time, a legislator's income derived from his place of residence and from the State capital will frequently vary. This problem is heightened by the fact that the Internal Revenue Service will not issue an advance ruling determining an individual legislator's tax home.

Consistent with their prior practice, many State legislators have continued to treat their residences in the districts they represent as their tax homes and have filed their Federal income tax returns in accordance with this practice, thereby deducting living expenses incurred in the State capital. The Service is currently challenging this practice and determining the tax home of a State legislator on a case-by-case basis. In some cases, this has resulted in a determination that the legislator's tax home is the State capital and in other cases, that his tax home is in the district he represents. If the Service determines that a legislator's tax home is the State capital, deductions taken for living expenses incurred in connection with the time spent at the State capital are disallowed. Although a deduction will then be allowed for living expenses incurred in the district the State legislator represents, in many cases the taxpayer (not having kept records of these expenses since they were not thought to be deductible) will not be able to substantiate those expenses. Many state legislators consider this inconsistent treatment and view the results as inequitable.

Furthermore, many believe that the \$3,000 limitation (established in 1952) on the deductions for living expenses of Members of Congress in the Washington, D.C., area is inappropriate since this is much less than is generally allowed in the case of business employees who are away from home on business overnight. Under present law, if an employer reimburses an employee for subsistence or provides an employee with a per diem allowance in lieu of subsistence, the employee may generally deduct up to \$44 per day for subsistence expenses incurred in connection with travel away from home (on behalf of his employer) without the requirement of substantiation. It is argued that legislators (both State and U.S.) should be entitled to treatment similar to that accorded other businessmen under present law.

The House bill

Under the House bill, for purposes of the deduction of trade or business expenses away from home by a State legislator, the home of a State legislator would be his place of residence within the legislative district which he represents. Deductions by a State legislator would be limited to an amount determined by the Internal Revenue Service. The IRS would apply rules of reasonableness and would take into account certain factors such as the number of days of legislative participation, the cost of living at the place where the legislature meets

and the amounts normally allowed businessmen under similar circumstances. An election would be provided for State legislators with respect to past periods.

Further, under the House bill, the $3,000 limitation would be modified to provide that deductions by a Member of Congress would be limited to an amount determined by the Internal Revenue Service. The IRS would apply rules of reasonableness and would take into account certain factors such as the number of days that the Members are away from home, the cost of living in Washington, D.C., and the amounts normally allowed businessmen under similar circumstances.

These provisions would apply to taxable years beginning after December 31, 1974.

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